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MARKET SIGHT LINES

Recent Inflation Readings Firm Up: Glimpses of Optimism Fade

By Michael O'Keeffe, *Chief Investment Officer*

Based in part on cooling inflation in the fourth quarter of 2022, both we and the market consensus view expected the Federal Reserve (Fed) to hike its funds rate another 0.5% in 2023 via two quarter-point moves. The Fed took a step in that direction at its first meeting of the year, bringing the funds rate up 0.25%. In this week's Sight|Lines, we share an update on investor reaction to the Fed meeting, firmer-than-expected January inflation reports, and an upward revision in fourth-quarter inflation readings compared to those previously reported.

THE TAKEAWAY: WITH FIRMER INFLATION, SOME OPTIMISM IS FADING.

The January inflation reports were firmer than expected. This shift means the Fed will very likely continue to hike rates further from here, more than were reflected in fed funds futures, or our forecast, earlier in the year.
In summary:

- The January consumer price index (CPI) and producer price index (PPI) were higher than expected.
- Fourth-quarter 2022 CPI and PPI inflation figures were revised higher.
- Fed futures are now signaling a total of 1% in 2023 rate hikes, 0.5% more than previously expected.
- We saw glimpses of optimism In January, with positive equity markets and lower interest rates, leaning toward our bull case scenario.
- With firmer inflation, some optimism is fading with a more active Fed, a giveback in equity market strength, and higher rates. We may even be leaning toward our bear case scenario.

In some ways, these patterns of uncertainty, and swings between positive and negative sentiment, reflect the volatility we've expected in the first half of 2023.

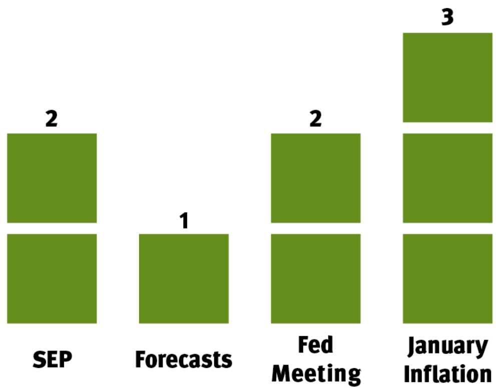
IN-DEPTH: FIRMER INFLATION MEANS THE FED MAY CONTINUE RATE HIKES, GOING HIGHER FOR LONGER THAN PREVIOUSLY EXPECTED. SOME OPTIMISM IS FADING.

The January inflation reports were firmer than expected, and while inflation is still cooling, the pace of decline has slowed. This shift means the Fed will very likely continue to hike rates further from here, possibly going farther than our forecast and the consensus views held earlier in the year. More rate hikes mean the glimpses of optimism we've seen for a Fed pause, and a decent chance of a soft landing, are fading. Going deeper:

- The January CPI and PPI were higher than recent months:
  - The January monthly CPI was up 0.5%, in line with expectations of 0.5%.
  - The January monthly PPI was up 0.7%, higher than the 0.4% expected.

- Fourth-quarter 2022 CPI and PPI inflation figures were revised higher:
  - The three-month average ended December for monthly CPI rose from 0.15% (which annualizes to 1.8%, below the Fed's 2% target) to 0.27% (which annualizes to 3.3%).
  - The three-month average ended December for monthly PPI rose from 0.03% to 0.13%.
- Figure 1 shows how fed funds rate forecasts have evolved:
  - The Fed's most recent Summary of Economic Projections (SEP), published in December, implied three quarter-point rate hikes, so two more 0.25% hikes this year.
  - At the beginning of the year, our forecast, and those implied by fed funds futures, reflected two quarter-point hikes, so one more from here.
  - Just after the Fed meeting, fed funds futures moved, then anticipating two more 0.25% moves this year.
  - The firm January inflation reports moved fed funds futures even further, now implying three more 0.25% hikes in 2023, for a total of four.

Figure 1
Number of 0.25% Hikes Left in 2023



Source: Stifel Investment Strategy data via Bloomberg, as of February 16, 2023

- We've continued to see volatility and uncertainty in 2023:
  - We saw glimpses of optimism In January, with the S&P 500 up 6.3% and the 10-year Treasury rate hitting a low of 3.37%. These lean toward our bull case scenario.
  - But some optimism is fading, with the S&P 500 off 1.8% so far in February and the 10-year Treasury rate again approaching 4%. We may even be leaning toward our bear case scenario.

In some ways these patterns of uncertainty, and swings between positive and negative sentiment, reflect the volatility we've expected in the first half of this year.

CONCLUSION

In our outlook for 2023, we explained that we expect to see volatility and uncertainty in the first half of the year as investors and the Fed parse inflation and economic data, watching for cooler inflation and how much the economy slows as a result of ever tighter Fed policy. In January, investors were getting optimistic as inflation was cooling in the fourth quarter of 2022, and the Fed appeared to be debating when to pause hikes. But firmer inflation in January has led investors to anticipate more Fed rate hikes, causing some optimism to fade.

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